

Internal Revenue Service  
**memorandum**

CC:TL:TS/P  
JCGIBBONS/crs

date: JAN 23 1991

to: District Counsel, Louisville CC:C:LOU  
Attn: Jennifer H. Decker,  
Senior Attorney

from: Chief, Tax Shelter/Partnerships Branch  
Tax Litigation Division CC:TL:TS/P

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subject:

TL-N-1230-91  
Gibbons/Sabin  
I.R.C. § 6212(a)

This is in reply to your request for tax litigation advice dated November 8, 1990.

ISSUES

1. Is the subject statutory notice of deficiency invalid under the reasoning of Scar v. Commissioner, 814 F.2d 1363 (9th Cir. 1987), rev'g. 81 T.C. 855 (1983), and its progeny, particularly Kong v. Commissioner, T.C. Memo 1990-480?
2. If the notice of deficiency is invalid, should you move to dismiss for lack of jurisdiction or should you settle the underlying substantive tax issues and file an agreed decision document?
3. Should you request formal technical advice in all cases with facts similar to the present case?
4. If in a factually similar case the petitioner does not question the validity of the statutory notice of deficiency, should you settle the underlying substantive tax issues and file an agreed decision without alerting the petitioner to the jurisdictional defect?

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### CONCLUSIONS

1. The subject statutory notice of deficiency is invalid under the reasoning of Scar and its progeny because the facts of the instant case are not meaningfully distinguishable from those in Kong v. Commissioner.
2. Because the notice of deficiency is invalid and the Tax Court lacks jurisdiction, you should move to dismiss this case.
3. You need not request formal technical advice with respect to cases appealable to the Ninth Circuit that have facts similar to the present case.
4. Because the statutory notice in a factually similar case would be invalid and the Tax Court would lack jurisdiction, settlement followed by an agreed decision would be unwise since jurisdictional defect may be raised at any time.

### FACTS

On [REDACTED], a statutory notice of deficiency, together with attachments, was issued to the petitioner respecting his [REDACTED] tax year. The notice informed the petitioner that an individual income tax deficiency had been determined, and it stated the amount of the deficiency in unequivocal terms. The last page attached to the notice set forth the following paragraphs:

In order to protect the government's interest and since your original income tax return is unavailable at this time, the income tax is being assessed at the maximum tax rate of [REDACTED] %.

The tax assessment will be corrected when we receive the original return or when you send a copy of the return to us.

In the statutory notice of deficiency, the respondent asserted a deficiency in the amount of \$ [REDACTED] as the result of the disallowance of partnership losses from [REDACTED] partnerships: [REDACTED], [REDACTED], [REDACTED], and [REDACTED]. In his petition, the petitioner acknowledged that these partnerships were correctly identified. As implied in the notice, a copy of the petitioner's actual return was not reviewed prior to the issuance of the notice; the administrative file is silent as to why. However, the administrative file does reflect that return information gathered from various Internal Revenue Service data bases as well as relevant third party information was reviewed before the notice was prepared and sent.

For example, a document entitled "Action Sheet" reflects that on [REDACTED], the Forms K-1 from [REDACTED], [REDACTED], and [REDACTED] were reviewed. The Form K-1 from each of these partnerships is incorporated into the administrative file. While the same "Action Sheet" reflects that losses and deductions were to be disallowed relative to [REDACTED], it does not record that a Form K-1 from [REDACTED] was reviewed, and the administrative file does not contain a copy of the same. It appears, however, that on [REDACTED], when the partnership loss information was written on the "Action Sheet," the person working on this case knew that the petitioner was linked to [REDACTED] because there is a Tax Shelter Inquiry (TSINQ) transcript in the administrative file dated [REDACTED], which reflects the linkage. In fact, in the margin of the TSINQ transcript next to the [REDACTED] linkage, are handwritten the same losses and deductions found on the "Action Sheet" and in the statutory notice. Because the district office and the employee charged with the [REDACTED] partnership return are designated by code on this TSINQ transcript, it is a strong probability that the margin notes were written during a telephone call to that employee made while the person working on this case was reviewing the TSINQ linkage. This probability is supported by the fact that the first page of the examination workpapers in the administrative file indicates that the [REDACTED] related adjustments were in proportion to the petitioner's interest therein. Thus, there is evidence that information from [REDACTED]'s Form 1065 (United States Partnership Return) and from petitioner's K-1 was considered.

The [REDACTED] TSINQ transcript also establishes that, before the statutory notice was sent, the linkages to [REDACTED] and [REDACTED] were confirmed. While the TSINQ transcript reflects that the petitioner was not linked to [REDACTED] on the Partnership Control System (PCS) for [REDACTED] a Form 6658, (Notice of Examination of Flow-Through Entity) dated [REDACTED], is laced in the administrative file, indicating that the petitioner's linkage to [REDACTED] was confirmed before the [REDACTED] issuance of the statutory notice. The petitioner's Form K-1 from [REDACTED] was attached to this Form 6658 when it was sent to the examination support staff. The copy of the petitioner's return for [REDACTED] reflects that the amounts listed on the Forms K-1 for [REDACTED], [REDACTED], and [REDACTED], and disallowed in the statutory notice were, in fact, claimed as deductions and/or losses by the petitioner. As for deductions disallowed with respect to petitioner's [REDACTED] interest, \$[REDACTED] of losses and deductions are clearly identified on his return as flowing from [REDACTED], and the statutory notice disallowed the same. Although the petition

filed in the case alleges that only \$ [REDACTED] was claimed relative to [REDACTED], such is not the case. On page 2 of the attachment to his return, the petitioner claimed a \$ [REDACTED] partnership loss and an \$ [REDACTED] short term capital loss from [REDACTED]. In addition, on page 3 of that attachment to his return, the petitioner listed \$ [REDACTED] as a miscellaneous itemized deduction from [REDACTED]. These losses and deduction total \$ [REDACTED].

In addition to the "Action Sheet," the TSINO transcript, the Forms K-1 and the Form 6658, there is an master file (ACTRA) transcript in the administrative file which establishes that return information was reviewed by the respondent prior to the issuance of the statutory notice. The transcript reflects that it was run in cycle [REDACTED], which was in [REDACTED], that the petitioner's filing status was single, and that the petitioner reported \$ [REDACTED] as tax for [REDACTED] but no taxable income. Because the Form 5278 (Statement-Income Tax Changes) attached to the statutory notice includes \$ [REDACTED] as tax reported by the petitioner but no taxable income, it seems certain that the preparer of that form reviewed the ACTRA transcript in the administrative file.

While information from the ACTRA transcript was used to determine the taxable income and tax reported by the petitioner, and while that information was used to reduce the deficiency determined after computing the corrected tax liability, it was not used in calculating that tax liability. Rather than using the appropriate tax rate schedule for [REDACTED], the person preparing the statutory notice used the "plug rate" of [REDACTED]%. Accordingly, failure to fully utilize the ACTRA transcript information, particularly as it related to the correct rate of tax, produced a proposed deficiency approximately one-third larger than it would have been had all available return information been considered.

In summary, the statutory notice in the instant case included the correct adjustments in the correct amounts, but it computed the petitioner's tax liability by using an inappropriate plug rate, by computing the deficiency by multiplying the disallowed amounts by the maximum tax rate.

You have identified 36 cases in your office with facts similar to the instant case. Those cases and the instant case are appealable to the Ninth Circuit Court of Appeals.

In Scar v. Commissioner, the court of appeals reversed a Tax Court decision that had found valid a notice of deficiency that on its face revealed that the deficiency asserted was computed without benefit of the taxpayers' return or return information. The appellate court found that no determination had been made for purposes of I.R.C. § 6212(a).

The factors that the appeals court found significant in Scar were:

1. The notice of deficiency purported to make an adjustment with respect to a tax shelter in which the taxpayers had no interest rather than with respect the shelter with which the taxpayers were involved;
2. The notice did not adjust the taxpayers' income as reported but merely computed a deficiency by multiplying the disallowed loss by the then maximum tax rate; and
3. The notice of deficiency informed the taxpayers that the maximum rate of tax was being applied to the adjustment because the issuing office did not have the taxpayers' return. <sup>1/</sup>

Clapp v. Commissioner, 875 F.2d 1396 (9th Cir. 1989) provided a second opportunity for the Ninth Circuit to consider Scar and to refine the intentment of Scar. The Ninth Circuit stated at 1402:

Furthermore, as the Tax Court has since pointed out, Scar did not even require any affirmative showing by the Commissioner that a determination set forth in an alleged notice of deficiency was made on the basis of the taxpayer's return. Only where the notice of deficiency reveals on its face that the Commissioner failed to make a determination is the Commissioner required to prove that he did in fact make a determination Campbell v. Commissioner, 90 T.C. 110 (1988)

Scar, thus, appears to apply when the statutory notice reveals on its face that it was prepared without reference to the taxpayer's reported tax liability.

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<sup>1/</sup> The Scar notice stated that, in order to protect the government's interest and since the original income tax return was unavailable at the time, the income tax was being assessed at a maximum rate of 70%.

The Tax Court recently expressed its understanding of Scar and Clapp in Kong v. Commissioner, T.C. Memo 1990-480. There, the taxpayer, whose case would be appealable to the Ninth Circuit, received a notice of deficiency stating:

In order to protect the government's interest and since your original income tax return is unavailable at this time, the income tax is being assessed at the maximum rate of 70 percent.

The tax assessment will be corrected when we receive the original return, or when you send a copy of the return to us.

The Kong notice correctly identified the disallowed loss both as to source and amount and is, thus, different than the notice in Scar. However, the deficiency, as indicated above, was computed at the maximum tax rate rather than at the rate that would apply had the Commissioner related the disallowed loss to the taxpayer's reported liability. Notwithstanding the factual differences between Scar and Kong, the Tax Court held that Scar applied and that the notice of deficiency was invalid because the Commissioner did not fully use the return information available to him in computing the deficiency; rather he merely multiplied the disallowed loss by the maximum tax rate.

The instant case is not distinguishable from Kong in any meaningful way. The instant case is appealable to the Ninth Circuit. The notice of deficiency contains the "smoking gun" language about the interest of the government and the application of maximum tax rate. Just as in Kong, the computation of the deficiency was not related to the taxpayer's reported tax liability. Rather the deficiency was "arrived at" by multiplying the disallowed loss by the maximum tax rate. As alluded to earlier, if the return information available had been fully used, the taxpayer's deficiency would have been computed using a lower tax rate.

Accordingly, we believe that the Tax Court would find that a determination has not been made within the meaning of I.R.C. § 6212, that the notice of deficiency is invalid and that the court lacks jurisdiction.

Because the subject statutory notice is invalid, the Tax Court has no jurisdiction. See Stamm International Corporation v. Commissioner 84 T.C. 248 (1985) and Midland Mortgage Co. v. Commissioner 73 T.C. 902 (1980). As officers of the court, you should apprise the court of the jurisdictional defect through a motion to dismiss. Settlement with the petitioner followed by an agreed decision document would always be open to attack because jurisdictional questions can be raised at any time.

In the future, you need not request formal technical advice in cases appealable to the Ninth Circuit where the notice of deficiency contains the smoking gun language and the facts indicate that the Commissioner did not fully use return information to relate the deficiency to the taxpayer's reported tax liability.

Further questions should be directed to Jim Gibbons at FTS 566-3233.

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